

CHAPTER 13

BANKRUPTCY AND ITS RELATIONSHIP TO FEDERAL GOVERNMENT CONTRACTS

I. INTRODUCTION.

II. REFERENCES.

A. AR 27-40

B. Title 11, U.S. Code

C. Federal Rules of Bankruptcy Procedure

D. Points of Contact

1. Army – Mackey Ives, Army Litigation Division, 901 N. Stuart St., Arlington, VA 22203; (703) 696-1616
2. Air Force –Mr. Chris Cole, (703) 696-9087
3. Navy/Marine – Mr. Robert Taylor, (202) 695-0782
4. U.S. Coast Guard- LCDR Michele Bouziane, (202) 267-1040
5. DoD – Mr. Mark Barta, DFAS, (614) 693-6842

III. COURT ORGANIZATION.

- A. District Courts have original and exclusive jurisdiction over all cases under Title 11. 28 U.S.C. § 1334(a). The District Courts shall have original but not exclusive jurisdiction of all “*civil proceedings*” arising under, arising in, or related to bankruptcy. 28 U.S.C. §1334(b).
- B. Jurisdiction Hearings. Bankruptcy cases are “*referred*” to the Bankruptcy Judge by the District Court. 28 U.S.C. § 157. The District Court may withdraw the “*reference*” sua sponte or upon motion.

- C. Appeals. Taken to the Bankruptcy Appellate Panel (BAP), if one exists, or to the District Court, and then, to the Circuit Court of Appeals. 28 U.S.C. § 158.

IV. CHAPTER 12 (family farmer) AND CHAPTER 13 (wage earners).

V. CHAPTER 7 – LIQUIDATION.

A. PURPOSE.

1. Orderly liquidation of debtor's non-exempt assets
2. Filed voluntarily (11 U.S.C. § 301) or involuntarily (§ 303)

B. WHO MAY FILE?

1. Individual debtors
2. Partnership or corporation (§§ 101(41), 109)

C. FILINGS.

1. Schedules of Assets/Liabilities (Federal Rules of Bankruptcy Procedure (FRBP) 1007(b))
2. Statement of Financial Affairs
3. Statement of Executory Contracts
4. Petition for Bankruptcy
5. Must be filed within 15 days after order for relief

D. TRUSTEE.

1. Interim trustee appointed who serves until selection of trustee at First Meeting of Creditors
2. First Meeting of Creditors held within 30 days ("Sec. 341 Meeting") after the order for relief (11 U.S.C. § 341)

3. Election of Trustee (11 U.S.C. § 702)
4. Duties (§ 704)
 - a. Representative of the debtor's estate
 - b. Capacity to sue and be sued (§ 323)
 - c. Authorized to operate the business for a limited time period (§ 721)
 - d. Principal duty is to liquidate the assets for distribution to the creditors (§ 725)
 - e. Trustee's primary job often is to liquidate the estate. This may take time. Example: In re Precision Machining, Inc., No. 94-04377 (Bankr. N.D. Fla.) – pending sale of two properties since 1994

E. LIQUIDATION

1. Secured creditors often deplete the assets (banks, lien holders) such that unsecured creditors receive very little
2. Priority claims paid FIRST and in FULL (§ 507)
 - a. Administrative expenses (LAWYERS FEES!!)
 - b. Certain unsecured claims for wages and salaries
 - c. Certain unsecured claims for contributions to wages or salaries
 - d. Certain unsecured claims for contributions to employee benefit plans
 - e. Unsecured tax claims
3. Remaining Claims - Paid by Class (§ 726)
 - a. Unsecured claims (proof of claim holders)
 - b. Claims filed late
 - c. Claims for fines and penalties in excess of actual pecuniary loss
 - d. Claims for interest

- e. Rule – If there is insufficient money to pay in full all of the claims in a particular class, the claims in that class are paid on a *pro rata* basis.
- 4. Assumption or Rejection of Executory Contracts. Debtor has 60 days to decide in a Chapter 7 case (§ 365)

F. DISCHARGE

- 1. The GOAL of a Chapter 7 debtor!!!
- 2. Exceptions
 - a. Debts resulting from debtor's fraud, false pretenses, embezzlement, larceny, debts not listed on schedules are NOT discharged. (§ 523)
 - b. Taxes and Student Loans are not discharged. (§ 523)

VI. CHAPTER 11 – REORGANIZATION

A. PURPOSE

- 1. Most significant form of bankruptcy. While the number of filings for Chapter 11 is significantly less than Chapter 7, approximately 75% of all liquidation (Chapter 7) cases are “no-asset” or nominal asset cases. A Chapter 11 proceeding allows the debtor to reorganize its business and administer the equitable distribution of payment of creditors.
- 2. Intended to give debtor a FRESH START. (In re Talladega Steaks, Inc., 50 B.R. 42 (Bankr. N.D. Ala. 1985).
- 3. Intended to provide an orderly and ratable distribution to creditors. (*Pro rata* share with respect to similarly situated creditors)

B. WHO MAY FILE?

- 1. Individuals (rarely)
- 2. Corporations, partnerships, sole proprietorship

C. INITIAL PROCEDURES

- 1. Debtor files Petition (may be voluntary or an involuntary filing) (§§ 301, 303)

2. Automatic Stay IMMEDIATELY imposed on ALL creditors!!! (§ 362)
- a. The most powerful injunction in the law!!
 - b. Takes effect immediately upon the filing of the bankruptcy petition
 - c. Permits the debtor to reorganize its affairs, provides “breathing room” for the debtor
 - d. Creditors prohibited from taking any adverse action against the debtor and its subsidiaries. Adverse action includes terminations, stop work orders, withholding payment to punish debtor, set-offs, actions to recover property, discriminating against the debtor, etc. (§ 362(a))
 - e. Does not apply to post-petition contracts
 - f. Does not apply to actions against the surety/insurer
 - g. Authority of Contracting Officer **BEFORE** Bankruptcy
 - (i) May terminate for default (FAR Part 49)
 - (ii) May terminate for convenience (FAR Part 49)
 - (iii) May decide NOT to exercise option (FAR Subpart 17.2)
 - (iv) Actions to setoff debts against contract, suspend work, issue stop-work orders (FAR Subpart 42.13)
 - h. Authority of Contracting Officer **AFTER** Bankruptcy filed
 - (i) Terminate – LIFT STAY
 - (ii) Recover Inventory – LIFT STAY
 - (iii) Setoff – LIFT STAY
 - (iv) Exercise Option – Maybe (See In re Exquisito Services, Inc., 823 F.2d 151 (5th Cir. 1987))
 - (v) Progress Payment Inventory – LIFT STAY

- i. Relief from Stay granted if the debtor does not have equity in the property and such property is not necessary for an effective reorganization. In re Sun Valley Newspapers, Inc., 171 B.R. 71, 75 (B.A.P. 9th Cir. 1994)
 - j. Actions taken in violation of the stay are either void or voidable (depends on Circuit). Contempt citation and/or punitive damages can be imposed
3. Creation of the Estate (11 U.S.C. § 541)
- a. No Trustee is appointed for a Chapter 11 case unless cause shown (fraud, dishonesty, incompetence, and gross mismanagement) (§ 1104)
 - b. Debtor becomes “debtor-in-possession”
 - c. DIP has rights, powers, and duties of a reorganization trustee (§ 1106)
 - d. DIP has authority to operate the business (§§ 1101, 1107, 1108)
 - e. The “estate” consists of all legal and equitable interests of the debtor as well as any interest acquired after the petition filing. (§ 541)
4. Debtor generally files “First Day Motions”
- a. Motion to Assume Bank Accounts
 - b. Motion to Pay Critical Vendors
 - c. Motion Pay Employees
 - d. Motion for Interim Financing
5. Debtor’s Required Filings.
- a. File List of Creditors
 - b. Schedule of assets and liabilities
 - c. Statement of Financial Affairs (§ 521; FRBP 1007)

D. ADMINISTRATION OF THE CHAPTER 11 ESTATE

1. Committee of Creditors

- a. U.S. Trustee appoints a committee of unsecured creditors (§ 1102(a)(1))
- b. Consists of the 7 largest unsecured creditors
- c. U.S. Government and its agencies normally do not serve on such committees

2. Committee Tasks

- a. Determines whether business should continue to be operated
- b. Whether a Chapter 11 trustee should be appointed
- c. Conduct an investigation of the financial affairs of the debtor
- d. Consult with the DIP or trustee in the administration of the estate (§ 1103(c))
- e. Participate in the formulation of the Plan of Reorganization (§ 1103(c)(3))

3. First Meeting of Creditors (§ 341)

- a. Convened by U.S. Trustee within a reasonable time after the filing of the bankruptcy petition
- b. Creditor's committee conducts its business, including selecting/nominating attorneys to represent the creditors
- c. Opportunity for the unsecured creditors to query the debtor
- d. DoD representatives normally do not attend. Occasionally, the Assistant U.S. Attorney (AUSA) will attend. (§§1102; 101(33))

4. Disclosure Statement (§ 1125) and Reorganization Plan (§ 1123)
- a. Essentially a contract between the debtor and his creditors in which creditors are divided into classes
 - b. Must be filed within 120 days of petition filing (§ 1121(a))
 - c. Debtor has 60 days from filing of the Plan to get Plan approved, i.e., Debtor has total of 180 days to file and get Plan approved (§1121(c)(3))
 - d. Creditors can reduce the debtor's period to file a plan (§1121(d))
 - (i) Courts consider size of the debtor
 - (ii) Difficulty of formulating a plan (In re Texaco, Inc., 76 B.R. 322 (Bankr. S.D.N.Y. 1987)
 - (iii) Whether a successful reorganization is possible (Matter of American Federation of Television and Radio Artists, 30 B.R. 772 (Bankr. S.D.N.Y. 1983)
 - (iv) Whether the extension would unreasonably delay the proceedings
 - e. States which claims are “impaired” and “unimpaired” (§1123(a)(1))
 - f. Creditors in a given class must be treated in the same way unless consent to less favorable treatment is obtained. See In re Dow Corning Corp., 280 F.3d 648 (6th Cir. 2002).
 - g. Adequate means for execution of the plan must be set forth in the Plan (§ 1123(a)(3))
 - h. Before Plan can be executed, it must be accepted by the creditors and confirmed by the Court (§§ 1126, 1128, 1129). Normally, a hearing is held to determine whether the Plan should be accepted (2/3's in amount and 1/2 in number vote for Plan)
 - i. Confirmation of the Plan vests all property of the estate “free and clear of all claims of creditors” with the debtor. (§1141(c)). Confirmation of the Plan acts as a discharge of all preconfirmation debts and is tantamount to “settlement” in civil litigation. The debtor is obligated to execute the Plan with Court oversight (§ 1141; BR 2030(d))

j. Plan must address Executory Contracts (see below)

5. Objections to Disclosure Statements and Reorganization Plan

- a. Most common objection – Plan does not contain “adequate information” sufficient in kind and detail to make an informed judgment about whether the Plan is “workable” and offers a reasonable prospect of success. In re Monnier Bros., 755 F.2d 1336 (8th Cir. 1985); In re Jartain, Inc., 44 B.R. 331 (Bankr. N.D. Ill. 1984)
- b. “Adequate information” includes information regarding the directors and officers, their salaries and compensation, financial forecasts, all funding sources, the business’ pre-petition history and the intentions regarding key employees, a liquidation analysis, outstanding litigation, insider transactions, and tax consequences of the reorganization. See In re Beko Vending, 67 B.R. 234 (Bankr. D. Mass. 1986).
- c. Objections must be filed with the court, served on the debtor, the trustee, and any creditor committees. FRBP 2002, 3016, 3017
- d. U.S. Government representatives must review the Plan to ensure it addresses ongoing procurement actions and provides a reasonable expectation of success
- e. The Court has authority to approve a Plan over the objections of a dissenting class of creditors if the Plan conforms to Section 1129 (Often called a “cram-down”)
- f. Plan may not be confirmed if the ***Absolute Priority Rule*** violated (junior claim holder receives any property while a more senior unsecured claim holder receives less than his allowed amount). See Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988)

6. Executory Contracts (§ 365)

- a. Not defined by the Bankruptcy Code. Performance remains due on each side. (“A contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.” Professor Vern Countryman, *Executory Contracts and Bankruptcy*: Part 1, 57 Minn. L. Rev. 439 (1973).

- b. Contracts that are substantially performed are NOT executory. See Heartline Farms v. Daly, 128 B.R. 246, 250 (D. Neb. 1990)
- c. What is a contract? Probably not “Task Orders” or “Delivery Orders” that are issued under a larger umbrella contract
- d. The Code allows the DIP (or Trustee) to “accept or reject” any executory contract prior to Plan Confirmation. (See N.L.R.B. v. Bildisco, 465 U.S. 513 (1984))
 - (i) The DIP or Trustee may reject contracts that are “burdensome” (unprofitable).
 - (ii) If the contract is in default (most of them are!!), the DIP must “CURE” any defaults and provide adequate assurance of future performance prior to assuming the contract(s)
 - (iii) Subject to Court approval!!!
- e. “Bankruptcy No Man’s Land” - - What is the status of a Government contract between when the Petition is filed and the Plan Confirmed (180 days later?) (contract has neither been assumed nor rejected). See US v. Carolina Parachute Corp., 907 F.2d 1469 (4th Cir. 1990); NLRB v. Bildisco, 465 U.S. 513 (1984); In re Sharon Steel Corp., 161 B.R. 934, 937 (Bankr. W.D. Pa. 1994)
- f. “Assumption or Rejection”
 - (i) U.S. Government may accelerate decision timeline (60 days for Chapter 7; Until Plan Confirmation for Chapter 11).
 - (ii) Court’s consideration is limited to whether the proposed action will benefit the reorganization effort. See In re By-Rite Distributing, Inc., 47 B.R. 660, 668 (Bankr. D. Utah 1985)
 - (iii) “Curing” defaults or compensation for pecuniary losses must be resolved by the Court prior to approving assumption (§ 365(b)(1))
 - (iv) “Assumption” or “Rejection” of contract should be expressly approved by the Court to avoid “implied assumption doctrine.” (failure to notify counsel of bankruptcy filing and motion to assume contract may result in DOJ refusal to file motion to lift stay).

(v) Claims arising from an “Assumed” contract constitute administrative expenses of the estate (higher priority) (§§ 364, 507) [“A contract expressly assumed is considered a post-petition contract entitled to priority of payment under Sec. 507.”]

(vi) The Anti-Assignment Act (31 U.S.C. § 3727; 41 U.S.C. § 15) precludes the DIP’s assumption of an executory contract without the consent of the U.S. Government. See In re West Electronics, Inc., 852 F.2d 79 (3d Cir. 1988)

(vii) “Rejection” constitutes a breach as the day before the petition date (prepetition claim) (§ 365(g)). The U.S. Government may recover costs under the “Default” clause and becomes prepetition unsecured claims. The benefit for the debtor is that the prepetition claim is discharged in bankruptcy.

(viii) Contract continues in force and effect if assumed. Army gets administrative expense priority claim for all obligations of the contractor arising under the assumed contract. See e.g., In re U.S. Metalsource Corp., 163 B.R. 260, 269 (Bankr. W.D. Pa. 1993)

(ix) Assignment. Non-assignment Act generally prohibits but Government can waive protections of the Act. To assign executory contracts, debtor must assume contract and provide adequate assurance of future performance.

7. Voidable Preferences. (§ 547)

8. Closing of Cases. After the estate is fully administered, the court issues a final decree. (§ 350; FRBP 3022.)

VII. CONTRACTING ISSUES IN BANKRUPTCY

A. Notice of Bankruptcy Action.

1. Clerk of Court required to notify government of bankruptcy if debt to US Government disclosed (FRBP 2002(j))
2. AR 37-103, chapter 13 requires commands to notify DFAS of bankruptcy and DFAS in turn notifies all procurement commands of the bankruptcy.

B. Automatic Stay Limitations.

1. Applies only to the ‘bankrupt estate’

2. Does not apply to “police, regulatory actions.” Example: Suspension and debarment actions could be regulatory actions designed to protect the public from dealing with non-responsible contractors. Test: Public policy v. pecuniary purpose? See In re Medicar Ambulance Co., Inc. 166 B.R. 918, 926-7 (Bankr. N.D. Cal. 1994)
3. Does not apply to postpetition contracts. See Gull Air, Inc., 890 F.2d 1255 (1st Cir. 1988)
4. Contracting Officer generally must obtain “relief” from the stay to take any adverse action
5. If you SUSPECT a contractor is going to file for bankruptcy, take IMMEDIATE action!!
6. Contracting Officers have FAR authority PRIOR to bankruptcy and precious little authority afterwards.

C. Specific Contracting Issues (Top Ten Bankruptcy Issues).

1. Filing Proof of Claim (§§ 502, 506)
 - a. Normally filed by DFAS on behalf of DoD
 - b. Have 180 days from petition date to file claim
 - c. “Claim” is broadly defined; any possible fact which may furnish the basis for a money claim against a debtor
 - d. Government takes a *pro rata* share as an unsecured creditor
2. Adverse Actions against debtor? Can I terminate a contractor before he files for bankruptcy? Afterwards?
3. Recoupment. An equitable defense that permits a nondebtor to withhold payments to recover overpayments arising from the same transactions (may recoup pre/post payments; no requirement to lift automatic stay because this is an accounting action not a collection action). See Brooks Shoe Mfg. Co., Inc. v. United Telephone Co., 39 Bankr. 980 (E.D. Pa. 1984); In re TLC Hospitals, 224 F.3d 1008 (9th Cir. 2000)

4. Payment? (May place an “administrative freeze” on payments). See Bank of Maryland v. Strumpf, 516 U.S. 16 (1993). Withholding payments due debtor pending bankruptcy court approval of setoff is allowable as long as setoff not actually effectuated.
5. GFP? Title or Lien? Government has title to, and right to possession of parts, materials, inventory, and work in progress that is the subject of progress payments. See FAR 52.232-12, 232-16; See In re Reynolds Manufacturing Co., 68 B.R. 219 (Bankr. W.D. Pa. 1986); In re Economy Cab and Tool Co., 47 B.R. 708 (Bankr. D. Minn. 1985); In re American Pouch Foods, 30 B.R. 1015 (N.D. Ill. 1983), Skip Kirchdorfer, Inc. v. United States, 6 F.3d 1573 (5th Cir. 1993). Seek abandonment by Trustee (§ 544), seek declaratory judgment, file complaint for turnover (§ 542), or file motion seeking adequate protection.
6. Should I do business with a bankrupt contractor? Can I discriminate against a bankrupt entity? (Cannot base a finding of non-responsibility based solely on the fact that a contractor has filed for bankruptcy). See In re Exquisito Services, Inc., 823 F.2d 151 (5th Cir. 1987) (under Section 525, held that the USAF could not deny option based solely upon the fact that contractor had filed bankruptcy)
7. Assumption / Rejection / Cure / Consent of US Government under Anti-Assignment Act
8. Taking care of Subcontractors. See FAR 49.402(b) (Termination ILO Default)
9. May I talk to the debtor?? Can my counsel talk to the debtor? Surety??

VIII. CONCLUSION

